How China’s proposed property tax will help renters and first-time buyers

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For almost 20 years, my colleagues in the property industry and I have discussed an anomaly in China’s property market and that is specifically that there is no annual tax for owning residential property. That means that there is effectively no holding cost to owning residential property in China, if you ignore maintenance which most owners do, and if you neglect to pay property management fees which a shocking number of owners also do.

Add to this a trend where property prices have in general risen over the past couple of decades and what has resulted is a market where price increases have rewarded a small group of wealthy investors who have accumulated a significant amount of property, much of which is paid for, but sits vacant. These residential units are not making their way into the rental market because owners know the return on renting it out, including having to complete the interior construction, has paled in comparison to what they can achieve by just sitting on the property and waiting for prices to rise further. This has resulted in a market where some hoarded property, while others work hard to try and afford their first home. Effectively there is a lot more property available than most people realize, but the ownership is concentrated in the hands of a few who often let it sit vacant.

However, in early March, at the “Two Sessions” of the National People’s Congress, the chairman of the NPC standing committee Li Zhangshu, noted that a property tax would be among those taxes that would soon be implemented, without specifying exactly what that time line was. It is important to realize that this is at least the third time this topic has been brought up at this level signaling action is coming. Other discussions have noted that the tax would be locally implemented, meaning tax rates might vary some by location. One might hopefully interpret this reference to local, to also mean that the taxes would stay with the local government. If that is true, it would bring China in line with international practice where local governments generate taxes from local property and therefore have an interest in continuing to invest in local infrastructure projects to maintain valuable neighborhoods.

What this means is that potentially the government will start to levy an annual tax on each unit of residential property, or on each unit in addition to the primary home. In that case, a wealthy owner of multiple units is going to face an annual tax bill for each of these properties. Likely outcomes would be for such an owner to sell some units or rent out units that currently sit vacant to help cover the new tax bill. In either case, more units will become available for purchase and for rent and there is an argument that the prices might soften. This result would be in line with a sentiment that President Xi has shared recently when he was quoted as saying that “Houses are built to be lived in, not for speculation.”

At this point the conversation generally gets derailed by some pundit who claims that home owners in China already paid this tax and China is different because the government “owns” the land. This type of comment is a tired old saw trotted out by folks who don't really understand how property systems work. So yes, China has a property market based on a leasehold system. Guess what, so do many other markets including Hong Kong, Singapore and parts of the U.K. In most of those cases the developer pays an initial fee to the government to acquire the rights to develop the site some of which may be passed on to later apartment buyers. Then once the development is completed and sold, the apartment owner will be liable for a local annual property tax. What China is proposing is this second piece. China is at present fairly unique in that local home owners aren't taxed on an annual basis to help pay for benefits they enjoy including road, utilities, schools and parks.

There is currently a premium in China for residential units in districts with good schools. When a buyer purchases a unit in these areas they pay a premium price, but this doesn't benefit the local government who pays for the school. If a tax is brought in, the prices may soften, but an annual tax on the property owners will direct some of that "school district premium" to the local government in the form of tax income which can then help maintain the schools.

What level of taxation should home owners expect? I haven't heard of any rates being proposed publicly yet, but internationally, these sorts of taxes often range from half of one percent to one percent of the current assessed value of the property. That means that the government will need to update and maintain annual estimates of the price of property for each area and that owners who sit on property bought at historically low prices might be asked to pay taxes based on current rates. This is one reason why I would expect some owners who bought years ago at low prices might want to sell and take their gains and move them to other asset classes.

The impact to the commercial market

Many market watchers have lamented that Chinese cities are overbuilt with shopping malls and office towers. To some extent, this is a direct result of China's lack of a residential property tax. With no residential tax base, local governments have encouraged the development of malls and office buildings which result in sales taxes or corporate income tax of companies registered in those districts. So, if an annual residential tax slows down the development of yet another mall, that is probably an outcome we wouldn't complain about.

Outcome

While no one looks forward to new taxes, I think an annual tax on residential real estate might help change the market in fundamental ways. It would generate higher efficiency in how existing units are used and it might put tax revenues into the pockets of a local government who then has a vested interest in maintaining local schools and infrastructure and discourage them from developing unnecessary commercial real estate. More importantly it might discourage wealthy investors from hoarding property and thus put more units out into the market for home buyers and renters.

Possible outcomes to the proposed property taxes
1. Local governments will have a more stable and steady stream of tax income

2. Prices may weaken as more units are sold by owners who may soon face a large tax bill
3. There will be less pressure to develop commercial property (malls, offices, hotels)
4. Vacant apartments will be sold or leased to help cover these new tax costs
5. There will be more residential units available for lease
6. Schools may be funded relative to their local residential tax base
7. Other financial markets may see an increase of funds coming from former home owners

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